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Ugandan Securities Markets Development

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FINAL REPORT
UGANDAN SECURITIES MARKETS DEVELOPMENT

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Final Report

Ugandan Securities Markets Development: Recent Developments and Continuing Requirements

1. Introduction

The International Management and Communications Corporation (IMCC) undertook this study to evaluate the development of the Ugandan securities and capital markets and to offer recommendations on furthering the evolution of the domestic capital markets. In addition, while not originally contemplated, training activities were offered for the regulatory authority. This project was funded by the United States Agency for International Development (USAID) through the Consulting Assistance on Economic Reform project (contract number PCE-0405-Q-5016-00) at the Harvard Institute for International Development (HIID). IMCC is a subcontractor to HIID on this project.

Developing capital markets in emerging countries assists in achieving several objectives. Capital markets¹ help to mobilize assets and support economic growth and development. Other benefits include strengthening emerging market financial systems by, for example, helping to fight entrenched corruption, and reducing the risks of future financial crises. However, capital market development also brings certain problems, such as the economic shocks of foreign investors suddenly taking their money elsewhere. Accordingly, emerging markets need to strengthen the presence of domestic investors so that these markets can withstand the shocks of international flows of money.

Other USAID contractors have been assisting Uganda in the development of its capital markets, in particular KPMG Barents Group. To complement these efforts, our focus has been targeted in two distinct areas plus an overall assessment of Ugandan securities markets. The Statement of Work for this project calls for a Draft Report at the conclusion of the first field visit; this was completed. No comments were received and hence this report is also the Interim Report. The first area of focus involved specific training activities. Due to the medical incapacitation of the lead consultant for the Barents team, IMCC was requested to provide regulatory training to support continued progress and milestones set by the Capital Markets Authority (CMA). Training of the CMA board members and staff took place in December 1996.

The second specific area of focus involved technical assistance to modify the governmental debt issuance program. Major recommendations regarding debt issuance consisted of changing the auction method to a Dutch, or single price, auction, extending the maturity of debt instruments, and establishing primary dealers to help in developing a secondary market for government debt.

¹ The terms *capital markets* and *securities markets* are used somewhat interchangeably in this report. While similar, capital markets involve financial activities other than strictly securitized transactions. However, at the current stage of development in Uganda, the two terms can be used synonymously.

The discussion that follows is organized around the overall project objectives as presented in the Statement of Work. For reference purposes, Annex A provides a chronology of trips to Uganda, individual consultants used on the project, and specific objectives for each trip over the course of the project. The first section of this final report provides an inventory of accomplishments with respect to the Ugandan capital markets (Section 2), much of which was included in the Interim Report. A summary of technical advice and assistance offered concerning selected elements of the domestic capital markets follows next (Section 3). Documentation of training activities is provided as Annex B and represents one of the major objectives of the project. The next section (Section 4) discusses government debt issuance and focuses on activities that the government should consider for improving the availability of investment vehicles. This report comprises the Final Report as specified in the Statement of Work.

Capital markets are not created overnight. The Ugandan securities market is in its embryonic stage with a number of activities in various stages of development. Hence, when comments are offered here about future activities, these comments should not be viewed as critical of past efforts but as reminders of future targets and objectives.

2. Status of Capital Market Developments

Uganda has achieved a number of objectives but several major tasks remain to be completed. Recent progress has focused on governmental initiatives with the enactment of laws covering regulatory responsibilities and the creation of the Ugandan Securities Exchange (USE or Exchange). Other ancillary laws and regulations, such as authorization of unit trusts, are currently under review. On other fronts, progress has been slow as no shares of stock have been issued to the public from the privatization of parastatals. What follows is an inventory of the state of the markets for selected components of the capital markets.

Securities regulation

The Capital Markets Authority (CMA), the agency responsible for regulation and supervision of the securities markets, was formed following the enactment of laws in 1996 creating the CMA. As of August 1997, candidates for the chief executive officer have submitted their applications. A number of broker/dealers and investment advisors have been licensed. Staffing of the CMA continues with temporary staff from the Bank of Uganda (BOU). Operationally, necessary decisions are being made by the CMA and rules and regulations are in the process of being drafted and adopted. Once the CEO of the CMA is selected, the permanent staff needed to run the CMA can be identified, hired and an operating staff organization created.

Licensed Securities Firms

Licensed broker/dealers and investment advisors essentially include the same organizations at the present time. Currently licensed participants consist of affiliates of domestic and foreign banks operating in Uganda, other financial organizations (insurance), and selected financial sector firms with an African

presence. It seems that a core group of licensed participants are making the commitment necessary to insure that private sector participants assume control of the continued development of *their* securities exchange. The eight organizations licensed as broker/dealers represent a cross section of firms currently operating in the region. The absence of any of the larger foreign banks presently operating in Uganda is surprising. These organizations can always apply for licenses later, but by then they will have missed the opportunity to contribute to the development of the rules for the exchange and other strategic directions at the initial development of the domestic capital markets.

Institutional Investors

Whether operating as agents (broker/dealers) or principals, institutional investors in Uganda will become key participants for the continued development of the securities markets. The insurance sector is a major component of the domestic economy, and this sector is currently showing strong growth in premium income. The insurance sector is represented among the currently licensed broker/dealers. The national social security organization can be expected to be another participant in the capital markets. Presently, private pension schemes do not exist. In short, several institutional investors exist, and some are taking active roles as brokers.

Individual Investors

In addition to institutional investors, viable domestic capital markets require individuals' active participation. There is some evidence that capital is available within Uganda for investment opportunities as exemplified by a recently completed successful limited partnership fund raising effort. Furthermore, owners of private capital have been active bidders in companies being privatized. Individual investors play a very important role in capital markets and need to be cultivated during the evolutionary periods of a market's development. Government policies with respect to privatizations, taxation and government sponsored public education campaigns are needed to encourage more widespread participation by individual investors.

Uganda Securities Exchange

The Ugandan Securities Exchange has been launched, and a search is underway for a chief executive officer of the exchange. The appointments for this position and the CMA chief executive officer are critical to the development of capital markets within Uganda. Much of the progress to date has resulted from governmental initiatives and donor funded technical assistance. Thus, future efforts in preparing the rules for the USE will involve the chief executive officer of the USE, working with the licensed participants. Also, both parties collectively will need to raise capital to finance necessary infrastructure for the Exchange to be able to operate efficiently and smoothly. The private sector participants will need to recoup their investment and eventually realize profits from trading operations. However, the time table for assessing the profitability of forming a brokerage firm should extend over several years to allow the capital market to continue to develop and transaction volume to grow.

Infrastructure

A complementary infrastructure needs to evolve for clearing and settlement of security transactions conducted through the USE. Custodial services are not currently offered, and it is necessary for a limited number of custodian banks to provide safekeeping of securities. Also, an electronic payment system is

needed which should be managed by the BOU. None of this infrastructure is currently in place, and active trading on the USE has not evolved either.

Investment Vehicles

Presently, there are very few securities to trade. Essentially, no domestic stocks are available to trade. The central bank on a weekly basis issues Treasury bills which have market determined, positive yields. However, no secondary trading of these Treasury bills occurs currently. Money markets, typically distinguished from capital markets, need to evolve more completely since money markets provide the cash equivalent investment vehicles that support improved liquidity for capital market participants. Money markets are often the initial investment vehicles that emerge in the development of capital markets. Uninvested cash can be invested to generate returns and credit markets can be used to sell short-term debentures such as bankers acceptances and commercial paper.

In conclusion, Uganda has achieved a number of required objectives for domestic capital markets to evolve. Most of these accomplishments have required governmental initiatives and actions. However, much remains to be accomplished. The private sector participants, particularly the licensed dealers, need to take advantage of the momentum gained from recent achievements and keep up the pace of reform. Capital markets essentially serve the private sector by mobilizing assets. Thus, it is the private sector that has most of the responsibility for continuing the development of the domestic capital markets.

3. Evaluation of Achievements and Review of Future Requirements

For the domestic capital markets to continue to evolve, a number of activities need to be completed. This section reviews each of the topics discussed in the preceding section and identifies specific objectives and topics that have been discussed with counterparts over the course of the technical assistance phase. In addition, many of these topics were discussed during training sessions for the CMA. The report of training activities completed during the project is included as an annex to this report.

Securities Regulation

The CMA is at a crucial juncture. The CEO position needs to be filled with an experienced, qualified professional, as this appointment is critical to the successful development of the Ugandan capital markets. The appointment of a qualified person to this position will not assure success, but the appointment of a candidate with little or no experience in capital market development will severely, if not totally, limit the chance of success. Furthermore, the underlying basic philosophy of this new regulatory organization must be clearly established at the outset to preclude uneven decisions as the CMA evolves. The CMA is the enforcement agency for all laws, rules and regulations of the securities markets. This responsibility is based on the principle that the securities markets must be transparent and the interests of private investors protected. Maintaining investor confidence is fundamental to the development of capital markets.

As noted immediately above, the regulatory philosophy of the CMA, along with the qualifications and leadership abilities of the CMA, is critical to the long-term success of Ugandan capital markets. IMCC was able to acquire the services of a former Commissioner for Securities of Hong Kong to assist in CMA training activities. Uganda's regulatory law creating the CMA was modeled on the original 1974 Hong Kong regulatory law. Accordingly, we were able to provide a resource that could address specific examples about how the law has actually worked in Hong Kong and subsequent amendments that were adopted. Principal regulatory responsibilities of the CMA that were discussed in training sessions are summarized as follows:

1. As the CMA is responsible for the oversight of the exchange, including its clearing, settlement, and depository procedures, it should seek to ensure a fair and orderly market place for investors and efficient and adequate operational and risk management systems.
2. The CMA is responsible for licensing all dealers and investment advisers. The licensing function assures market participants, in general, and individual investors in particular, that the people and organizations with whom they have to deal are honest and financially sound. After licenses are granted, the CMA must continue to monitor each licensee's financial status and business practices.
3. The CMA should seek to ensure that there is fair treatment of shareholders and full disclosure of relevant information that might affect the price of quoted securities.
4. The CMA should authorize and approve applications by organizations wanting to distribute investment products to the public, i.e., unit trusts, mutual funds, limited partnerships.
5. The CMA should monitor trading activity on the exchange to detect any unusual movements in prices and volumes, which could indicate either insider dealing or price manipulation.
6. The CMA should consider monitoring the management, supervision and internal control guidelines instituted by registered financial sector professionals to devise at least minimum standards of conduct. The CMA should supervise the basic elements necessary for sound business practice in areas such as compliance, audit, management and supervision, and risk management.

In addition to the direct oversight of licensed dealers as described above, self-regulatory organizations (SRO) are widely used throughout the developed capital markets as well as emerging markets. These organizations are, as the name implies, bodies that provide oversight of their own members. SROs are most effective when the members are experienced and able to use the SRO to achieve regulatory objectives. This presents difficulties for emerging markets, as many of the broker/dealers in these markets are themselves learning the rules and regulations of their recently established securities market, learning what can go wrong and what needs to be done to avoid problems. SROs can still play a role during the early stages in the development of a securities market, however, since they provides a forum

for review of problems and an organization that can present a united viewpoint to the governmental regulatory body.

Licensed Securities Firms

Turning to broker/dealers, a small number of core participants have been licensed and their initial responsibility will be preparing rules for the operation of the Exchange. The rules for managing the Exchange, which must be prepared by this group of licensed participants (subject to approval by the CMA), will eventually apply to other broker/dealers that are licensed by the CMA. Thus, the initial brokers need to be mindful that the rules developed for the Exchange will apply to all participants. However, the overriding issue facing broker/dealers is to assume responsibility for the viable operation of the Exchange. The government must no longer be responsible for the development of the Exchange. Broker/dealers need to assert themselves and take charge of “their” exchange.

Broker/dealers, both individually and collectively, will need to make financial commitments and investments in the continued evolution of the USE. The infrastructure required to support the efficient and risk controlled processing of security transactions is discussed below. The point is that the brokers will need to invest time and money before profits from trading activities can be realized. Initially, the USE will require financial support from the broker/dealers before transactions grow to a size that can produce the revenues and profits to recoup these initial financial commitments. IMCC advisors discussed these issues at the initial workshop for licensed broker/dealers sponsored by the CMA.

Institutional Investors

A number of institutional investors already exist, namely insurance companies and the national social security fund. To expand this segment of investors further, creating private pension funds with mandatory contributions by employees has proven to be very effective in supporting capital market growth in other countries. This is a longer-term objective and not necessary for immediate capital market developments. However, the potential buying power of a large number of employees making regular contributions that are then invested in domestic and foreign securities is large and leads to a steady demand for securities. Furthermore, pension assets represent “patient” capital due to the long-term nature of the underlying liabilities. Pension assets can be committed to investments with long-term maturities, financing capital infrastructure of the country and long-term payout situations.

Individual Investors

There seems to be a growing portion of the population that has financial resources to invest in domestic securities. A number of policies could be considered to help reinforce the growth of individual investors. Public education campaigns are necessary to educate the populace about the USE and how to invest in securities that are traded on it. Privatization of parastatals, especially the larger economic enterprises that have more stable financial environments, should be structured to make shares easily available to the public. Shares of utilities in particular should have widespread appeal to individual investors. Thus, broad share distribution schemes could be developed and a portion of the shares in larger companies being privatized made available to the public. This type of program should be accompanied by a public education campaign focusing on how to participate and invest in newly issued shares of companies.

Tax policies can be adopted to provide tax-advantaged savings programs for retirement, i.e., individual retirement accounts (IRAs). Preferential tax treatment of long term capital gains would further encourage individual investors to raise savings levels. Other policy considerations include treating interest and dividend payments the same for corporate taxation purposes. Clearly, tax policies are major factors in encouraging individual investment.

Uganda Securities Exchange

The Exchange offers a place for agents to conduct purchases and sales of securities on behalf of their clients. While institutional investors may have sufficient insight and sophistication to understand the dealing environment, smaller individual investors need to be protected from potentially unscrupulous business practices. Security transactions for individuals could represent a significant portion of an individual's life savings. Thus, maintaining the integrity and transparency of the markets is critical for developing investor confidence. The USE and its members must present an open, fair forum where individuals can have their brokers transact purchases and sales of securities with integrity.

It is critical that the CEO of the Exchange have several years' experience at a high level in a recognized exchange. Security transactions involve an environment where the original issuer of the securities knows substantially more about the financial outlook for the company than its investors do. The regulatory system attempts to achieve full disclosure of these material facts. The Exchange needs to provide an environment where all transactions are treated in a fair and transparent manner. The buyer or seller of a few shares needs to be treated in the same manner as a buyer or seller of several thousand shares. An experienced CEO of an exchange will bring the background and knowledge necessary to insure that the exchange operates transparently and fairly.

Infrastructure

A new capital market requires a vast infrastructure to support the clearing and settlement of transactions. The eventual infrastructure will require a significant investment and thus any measures that could achieve savings should be carefully evaluated. Once a transaction has been concluded on the exchange, a number of actions take place to clear or verify the transaction and then to settle or consummate the trade. To support more active and efficient trading of securities, custodians and depositories provide safekeeping services. Security lending and derivatives help to make the markets more price efficient. However, these functions typically require a significant financial investment to achieve the necessary electronic connectivity and processing support.

Before the Exchange makes decisions requiring large financial commitments by domestic brokers, it may be advantageous to evaluate if economies of scale could be achieved through cooperation with other security exchanges in the region and affiliation with money center institutions. Clearing, settlement and custodial systems can cost millions of dollars to develop and require millions of dollars annually to maintain. At this time, Uganda does not require this level of investment in its infrastructure. However, plans and decisions made now could result in significant economies later. For example, securities traded on the London, New York, or Johannesburg exchanges could be traded on the USE with settlement through domestic financial firms with affiliations at each of these money centers. Adopting clearing, settlement and depository standards within the region will support trading of shares listed on other

regional exchanges. Ugandans could trade shares on the USE of companies listed in neighboring countries, London and Johannesburg. This capability could greatly assist the emerging dealers become financially established and offer domestic investors a more diversified mix of equities and bonds across broad geographical areas.

Both IMCC and KPMG conducted training sessions describing clearing and settlement systems and procedures. Smoothly functioning clearing and settlement systems help reduce risks significantly that a buyer (or seller) of securities may not readily acquire (dispose of) actual ownership of the securities that they believe they are buying (selling).

4. Issuance of Debt Securities

Capital markets for the world as a whole are approximately equally divided between fixed income (bonds) and equity (stocks) securities. Accordingly, it is important to develop securities in both of these asset classes. The major element missing from existing consulting assistance to Uganda has been with respect to fixed income securities, i.e., bonds. Most of the focus of other consulting assistance has been directed at stocks. To redress this omission, IMCC focused technical assistance on developing the government bond market through discussions with the BOU, the fiscal agent, and potential purchasers of government debt.

Bonds have been used as a source of capital for thousands of years and, historically, bond and short-term credit markets have preceded the development of stock markets. While the private sector has to assume major responsibilities for development of the equity markets, government often plays a key role in the development of the domestic bond market. The government is normally the best credit within an economy. The government needs to borrow in order to finance operating budget shortfalls, finance capital construction projects, and to refinance maturing debt. However, outside of the financing requirements, government-issued debt of various maturities forms the foundation for the economy's yield curve. Once the government has developed a government bond market domestically, domestic firms can more easily issue debt to local investors. Then, financial intermediaries can price debt off of the yield curve for government debt depending on the credit risk of the borrower. Other debt instruments that are priced off of the yield curve include residential mortgages, automobile loans, corporate bonds, etc.

The Bank of Uganda presently issues Treasury bills of three, six, nine and 12-month maturity. Should government debt of longer maturity be issued, then the government will have also reduced the budgetary risk from potential increases in interest rates. Most capital markets have natural buyers of longer maturity bonds. For example, insurance companies have known liabilities of specific duration and hence can match assets against liabilities by maturity. The existence of longer-term debt also produces a longer-term focus for investors within the overall economy. And, government needs to be aware of the longer-term impact of its economic policies. Thus, benefits accrue to both the financial sector and government from issuing debt across longer maturities.

The process of issuing government debt requires careful management, as the purchasers of debt need to be kept informed so that they can manage their purchases and sales of government debt, be aware of the expected financing requirements of the government, and assess supply and demand factors and any other condition that investors deem relevant. This is even more important in emerging capital markets where there are a smaller number of participants and fewer options for investors. Government issuers need to work with the primary dealers, announce their intent to issue securities and stick to the government's commitments to place debt, accept market determined interest rates, and respond to investors' concerns. Thus, in extending the maturity structure for Ugandan debt, the fiscal agent, the BOU, needs to announce its intent and most likely slowly extend the maturity of bonds offered depending on investor acceptance of the new bonds.

In markets with few participants, the Dutch, or single price, method seems to generate optimal results for the issuer. The Dutch auction systemically works against collusion, should participants share information about bids before auctions. Furthermore, the single price method takes away the winners' curse that adversely impacts successful bidders in a price discriminating auction. In the current price discriminating auction, the highest price bid must be above the average price for all bidders. Thus, the "best" bid ends up costing the successful bidder more than all other bidders end up paying for their securities. With a Dutch auction, all successful bidders pay the same price. Accordingly, bidders will act more aggressively to win bids and the issuer (the government) will not end up paying more money to issue bonds but will benefit from lower interest rates, i.e., less expensive debt.

After the domestic bond market begins to develop, it may be advantageous for the government to issue debt on the Eurobond market. These bonds are typically foreign currency denominated so that the issuer has to absorb currency risks or pay the cost of hedging currency risks. However, the benefits from using the Eurobond market can be several; the government issuance will help any subsequent domestic corporate issuer in the Eurobond market since the Uganda credit will be better known. The Eurobond markets can serve as a benchmark for interest rates received on debt issued domestically. And, it is always good to develop alternative investors should a domestic financial crisis emerge.

5. Conclusion

The Statement of Work calls for the contractor to assist the CMA with its on-going activities. One of the problems faced by the CMA is that it is charged with two potentially conflicting objectives, i.e., regulatory and supervisory responsibilities on one hand, and promoting the development of securities markets on the other hand. Also, it is important to begin a new regulatory function with a clearly defined regulatory philosophy and then to consistently follow the chosen regulatory approach. It is difficult to begin with a laissez-faire regulatory philosophy and then shift to a strict approach. The financial sector participants would be sent conflicting or inconsistent signals. These conflicts were brought to the attention of the CMA board and staff, as well as discussions of alternative regulatory philosophies. Clearly, the input of foreign advisors having longer experiences dealing with capital market issues is valuable to a newly created board such as the CMA. IMCC favors a strong regulatory approach and

the CMA board appreciated the foreign advisors' input on these issues. It will be important to monitor how the CMA board moves forward in appointing its executive director and in establishing its regulatory philosophy.

The contractor focused on working with four major groups whose actions will affect future capital market development – the CMA board, the CMA staff, the BOU (as fiscal agent), and the broker/dealer community. The government has taken the lead in providing the legal foundation for capital markets to develop. It is now up to the private sector participants to guide future developments with respect to domestic capital markets. At this point in the evolution of the capital markets, it is difficult to evaluate how private sector participants may respond to these challenges. If progress is slow, then future technical assistance may be helpful in guiding financial sector participants to a better understanding and use of the capital markets to achieve specific objectives. For example, if capital market participants fail to take a sufficiently active role, then strategic visitations to developed capital markets by a small, selected group of financial services providers may be advantageous.

Training for the CMA seemed to be well received, as conveyed by the Chairman of the CMA. Most of the discussion evolved around regulatory activities with respect to financial sector participants rather than with specific securities issues. This may have resulted from the fact that no stocks had been issued in Uganda. A major attraction was the participation of the former Commissioner of Securities for Hong Kong, which was particularly relevant since the Ugandan securities law was modeled after the original 1974 Hong Kong law. The Commissioner, Uisdein McInnes, was able to comment on specific sections of the Ugandan law and to explain where the Hong Kong authorities made subsequent amendments. The CMA board was especially interested in detailed examples of financial market activities that need to be regulated. In particular, comments about abuses of initial public offerings seemed to attract the board's interest. Future training and technical assistance should be directed at two objectives: 1) sharing "real life" regulatory experiences, and 2) a thorough review of the current Hong Kong law compared to the 1974 version.

Staff at the BOU seemed to understand the benefits of extending the maturities of government debt, issuing debt using primary dealers, and other technical recommendations offered with respect to the fiscal agency role. Comments by staff were favorable with respect to core recommendations. To achieve implementation of the recommendations, additional technical assistance may be required concerning specific elements of debt issuance. However, senior-level policy makers at the BOU and the Minister of Finance may need to be involved to actually realize changes in the fiscal agency program. Thus, future policy advice may be offered to these senior policy makers.

In conclusion, the technical assistance and training provided was well-received by the CMA board, CMA staff, BOU staff, and financial sector participants. However, without specific securities to trade, the Ugandan capital markets will evolve slowly. The foundation for future growth and development of domestic capital markets is evolving and the CMA and financial sector participants are gaining knowledge about their roles and responsibilities. The project contributed to this evolution of the capital markets through training of the CMA and recommendations with respect to developing a domestic bond market.

Annex A

Chronology of Technical Assistance and Training Activities

October 27 – November 8, 1996

David Weig, principle investigator for the project, visited Uganda and completed an initial assessment of the domestic capital markets and activities of the CMA. A Draft Report was prepared prior to departure and reviewed with USAID/Kampala and with CMA officials. Since no comments were received, this Draft Report became the Interim Report.

December 8 – 17, 1996

Other consultants assisting in the delivery of training to the CMA board and staff as well as licensed broker/dealers joined David Weig in the second visit to Kampala. These consultants included Uisdein McInnes, former Commissioner for Securities in Hong Kong, Phillip Torres, Associate Director for the portfolio management subsidiary of IMCC, and Andrew Spreadbury of KPMG Barents Group. Training activities involved discussing regulatory responsibilities with CMA staff and the CMA board. In addition, a conference was held for licensed broker/dealers discussing licensing and regulatory activities of the CMA. A training report was prepared and delivered to USAID/Kampala and the CMA.

July 26 – August 1, 1997

The final trip by David Weig provided technical assistance to the BOU concerning government debt issuance. Recommendations and rationale for proposals were discussed with BOU staff, presented to the CMA, and to broker/dealers. Mr. Weig also contributed to training activities by principally by Gary Stephenson, KPMG Barents Group concerning clearing and settlement procedures.

Annex B

Training for the Regulatory Authority

1. Introduction

The scope of work for this project has essentially three separate components; the initial focus consisted of an assessment of the institutional investor environment and related prospects for supporting capital market developments. The second effort required a series of training activities with particular focus on regulatory activities, and is the subject of this report. The third remaining activity is planned for technical assistance in the development of the secondary market for T-bills. These efforts are funded under USAID contract number PCE-0405-Q-5016-00 through the Consulting Assistance on Economic Reform program at the Harvard Institute for International Development.

As background, the Government of Uganda has taken the initiative in establishing capital markets through enactment of legislation governing the regulation of securities. Additional legislation has been drafted addressing other capital market activities such as the authorization of unit trusts. Furthermore, the Capital Market Authority (CMA, the regulatory body) is about to appoint a CEO. While no publicly traded equities exist at this point, the Government plans to issue shares to the public in the near future and, thus, it is important that the CMA staff its regulatory body. Hence, it was deemed important that training activities be provided to the CMA board and staff of the CMA at this time.

Following the medical incapacitation of the chief of party advising the Government in the development of their capital markets, IMCC was requested to assume responsibility for conducting training activities for the CMA. It was judged important to maintain momentum as the embryonic capital markets are developing investor interest, and training activities with respect to regulatory functions are absolutely critical at this juncture.

Regulation of security markets has taken different forms in various capital markets throughout the world. The regulatory philosophy of the advisors for this project clearly favors a stronger regulatory environment. The capital markets that have shown the greatest development (U.S.; Ontario, Canada; Chile) have adopted strong regulatory laws and practices. A stronger regulatory approach is highly recommended as it is important to develop and maintain investor confidence in the domestic capital market. This is even more important to a country like Uganda that is also going through privatization of government-owned enterprises and anticipates selling shares to the public. Investor confidence is difficult to earn but easy to lose.

Training topics of interest to the CMA consisted of discussions of trading systems, clearing and settlement procedures, and organizational structures for the regulatory body. The discussion and materials that follow summarize topics covered during the training sessions. Recommendations were proffered by the foreign advisors during the training sessions and are noted throughout this report. The

appendices include supplementary information, handouts during training sessions, and a list of those in attendance.

2. Regulatory Framework

In a developed capital market, the securities sector of the financial services group normally comprises three disparate, separate entities linked together by the law. They are:

- The securities market professionals, including the registered dealers in securities who may or may not be members of an officially recognized exchange.
- Then there is the recognized exchange, administered by duly elected representatives of its members, in accordance with the rules of the exchange.
- Finally, there is the regulatory authority that supervises the activities of the other two elements to ensure the law, together with rules and regulations, is being strictly enforced.

The reasons for the existence of the first two elements are not difficult to establish. The reason for an overall supervisory regulatory authority - The CMA - lies in the fact that a developed capital market must contain markets which are overtly transparent and in which the interests of the private investor are paramount and protected.

The underlying basic philosophy of a new regulatory organization like the CMA must be established at the outset to preclude uneven decisions as the regulatory organization evolves. It is helpful to review the regulatory philosophies and structures of other countries' capital markets at the initial stages in developing the Ugandan capital markets and regulatory philosophies. Following the review of the regulatory framework of major capital markets of the world, specific recommendations for the CMA are enumerated. The markets to be reviewed include the U.S. as an example of the most dynamic capital market and strong regulatory environment, the U.K., which recently restructured its regulatory environment, and Hong Kong from which the statutory language that created the CMA was based.

U.S.

Regulatory legislation in the U.S. evolved as a result of market abuses and lack of full disclosure in the 1920's that were thought to have contributed to the market crash of 1929. This legislation was part of the broad tendency towards intervention in the economy that characterized the New Deal. A series of laws were enacted between 1933 and 1940 including the Securities Act (1933), Securities Exchange Act (1934), Trust Indenture Act (1939), Investment Advisers Act (1940), Investment Company Act (1940), and also the Glass-Steagall (Banking) Act (1933). While these laws have been amended frequently since their enactment, the policy and regulatory framework upon which they were based has remained intact. The primary purpose of each act was the protection of uninformed, smaller investors. Regulation is achieved basically through disclosure of financial information and not approval of the merits of the offer. The Securities and Exchange Commission (SEC), in its actions and administrative orders, has contributed to the development of the stronger regulatory environment that exists in the U.S. Also,

self-regulatory organizations have been created that assist in regulating specific financial sector participants.

The evolution of capital markets has witnessed extensive new product development, particularly with respect to derivative instruments (e.g., futures, options). The regulation of these newer instruments needed to change from that contained in the Commodities Exchange Act (1936). Hence, the Commodity Futures Trading Commission (CFTC) was created in 1974 by an act of Congress. The CFTC is equivalent to the SEC and its powers similar in scope to the securities statutes. In the U.S., given the distinction between securities and futures, the regulatory environment includes two separate organizations. The distinction between what is a security and what is a future is becoming increasingly blurred. Thus, the regulatory environment has become somewhat confusing at times.

U.K.

The U.K. has a less developed regulatory system over its financial industry than the U.S. Major reforms and financial sector deregulation occurred in the mid-1980s which led to legislation enacted in 1986, the Financial Services Act. This law introduced self-regulation within a statutory framework. A non-statutory body, the Securities and Investment Board (SIB), was established which in-turn recognized several self-regulatory organizations (SROs). Further complicating the U.K. regulatory environment are the efforts of the European Union, while intended to simplify regulation across borders, often achieves the opposite result.

The U.K. structure has led to significant differences in regulation compared to the U.S., even though both countries use a senior regulator and SROs. The SIB has little involvement in the prevention of market manipulation and insider dealing, which is primarily the responsibility of the London Stock Exchange and prosecuting authorities. The SIB is responsible for ensuring that firms do not conduct any business without proper authorization. By policy and practice, the SIB has limited its regulatory powers over SRO members and regulating investment businesses directly. Thus, the U.K. offers an example of a less active regulator, although with broad investigative powers when needed.

Hong Kong

Hong Kong (HK) provides a capital market where a laissez-faire regulatory atmosphere has prevailed. Traditionally, the HK Government has adopted a hands-off approach to its economy with the assumption that the allocation of resources is best left to market forces. Accordingly, the stock markets were left virtually unregulated until the mid-1970s. The proliferation of stock exchanges (four operating and others planned) plus the stock market crash of 1973-74 prompted the enactment of a series of measures to regulate the markets and protect investors. Specific laws enacted included the Securities Ordinance (1974), the establishment of the Securities Commission, a Code on Take-overs and Mergers (1975), and the Commodities Trading Ordinance (1976).

This regulatory framework remained largely unchanged until the late 1980s. Given the rapid changes and increasing sophistication of both the securities and futures industries, the regulatory structure became somewhat outdated. The market crash of October 1987 led to the formal review of operations and

regulation of the securities and futures markets. In 1988, the Securities and Futures Commission was established which combined the regulation of securities and futures.

The benefits of the combined regulation of securities and futures are primarily in improved operational efficiencies. Registered dealers are often the same for both industries; the basic principles of regulation are the same as well. Savings in staff resources have been achieved with both the audit and surveillance functions and the investigative function where resources can be directed toward either securities or futures activities as required. Experienced staff are essentially interchangeable. This helps in managing the ever-present problem of the regulators getting to know the regulated too well.

Key Regulatory Responsibilities

Collectively, the foreign advisors to the CMA unanimously favor more regulation rather than less regulation. Experience has indicated that stronger, intelligible regulation, effectively and uniformly administered, produce the best regulatory regime. The basic philosophy of a regulatory authority is to provide an environment where markets and investments are encouraged to grow on a sound, long-term basis. The capital markets will in-turn contribute to the functioning of the economy and creation of wealth. Maintaining the integrity of the markets and investor confidence is fundamental to the achievement of these goals.

The principle regulatory responsibilities of the CMA can be summarized as follows:

1. Regular oversight of the exchange and its clearing, settlement and depository procedures. The CMA should seek to ensure a fair and orderly marketplace for investors and that the exchange's operational and risk management systems are efficient and adequate.
2. Licensing all dealers and investment advisers. The licensing function assures market participants in general, and individual investors in particular, have confidence that the people and organizations with which they have to deal are honest and financially sound. After licenses are granted, the CMA must continue to monitor each licensee's financial status and business practices.
3. The CMA should seek to ensure that there is fair treatment of shareholders and full disclosure of relevant information affecting the price of quoted securities.
4. The CMA should authorize and approve applications by organizations wanting to distribute investment products to the public, i.e., unit trusts, mutual funds, limited partnerships.
5. The CMA should monitor trading activity on the exchange to detect any unusual movements in prices and volumes that could indicate either insider dealing or price manipulation.
6. The CMA should consider monitoring the management, supervision and internal control guidelines instituted by registered financial sector professionals to devise at least minimum standards of conduct. The CMA should supervise the basic elements necessary for sound

business practice in areas such as compliance, audit, management and supervision, and risk management.

Experience has shown that even reputable firms which purport to follow high standards of conduct incur serious lapses that cause their firms, and the financial industry, losses of reputation, e.g., Barings, Jardine Fleming, Salomon Brothers.

Furthermore, the foreign advisors to USAID and the CMA strongly recommend that experienced, qualified professionals be appointed to the CEO positions at both the CMA and the Exchange. These appointments are pivotal to the success of both organizations and hence to the successful development of capital markets in Uganda. The appointment of qualified persons to these roles will not assure success, but the appointment of unqualified candidates will severely, if not totally, limit the chance of success.

The qualifications for the candidate for the CEO to the CMA should have, at a minimum, several years of regulatory experience in the regulatory sector, preferably securities regulation. For the post of CEO of the Exchange, a candidate must have several years of experience at a high level in a recognized stock exchange; e.g., in Hong Kong the first CEO of the exchange in Hong Kong (the newly amalgamated exchanged) had previously held the post of CEO of the London Stock Exchange.

The investing public have a right to expect qualified professionals at its regulatory authority and the exchange must know it is dealing with knowledgeable professionals of at least equal seniority. The two organizations have to respect the professionalism of the other.

3. Trading System for the Securities Exchange

The Chairman of the CMA expressed interest in reviewing alternative trading systems and discussing specific elements and steps in how the recommended trading system would function. While trading systems have been discussed with Ugandan officials on previous occasions, it will be necessary to discuss the proposed trading system in detail and actually go through simulated trading activities on several additional occasions and with each of the participating groups, i.e., regulators, brokers, etc. Thus, it is important to document and illustrate the recommended trading system so that all participants will better understand their respective roles and responsibilities.

Criteria considered in the selection of the recommended security trading system include the following:

- The cost of operating the trading system, which will ultimately be borne by investors.
- Ensure transparency of transactions which helps investors know they are treated equally.
- The trading system needs to be credible for both the dealers and investors.
- The trading system must be accessible to investors and provide the necessary liquidity for buying and selling securities.
- Traders need to have equal opportunity to deal on behalf of investors.

A “chalkboard” trading system is proposed for the Ugandan securities exchange. With this trading system, buy and sell orders are written on a chalkboard and when matches occur, transactions are consummated. This type of system has worked every efficiently in many parts of the world and replaced only when the sheer volume of transactions has made the system unworkable. Thus, until the transaction volume justifies greater investment in a more automated system, the chalkboard system offers several benefits with few disadvantages.

The chalkboard method of trading is simple, yet effective mechanism that can be implemented quickly and at low cost. Training requirements are minimized for brokers and investors. The single disadvantage is that if there are only a few broker/dealers, then there is a risk of broker influence on individual transactions.

A summary and analysis of alternative trading systems is provided in appendix C which was discussed in a training session. Other systems considered included (1) order-driven market system, (2) quote-driven market system, (3) floor trading system, (4) screen trading system, and (5) an automated trading system.

4. Clearing and Settlement of Completed Transactions

Before discussing the rationale for developing the specialized organizations that assist in the settlement of security transactions, it best to define terms and describe a typical security settlement structure. Even during embryonic periods in the development of capital markets, it is important to have third parties involved in the consummation of security transactions. This becomes clear as the systems and functions of clearing and settlement are discussed.

Once a trade has taken place on the floor of an exchange, the details of the trade are typically turned over to the “back-office” for processing. A clearing agent or clearinghouse provides for the verification of trade details by each party to a transaction. Each party affirms the facts of the trade, i.e., the security, quantity, price, commission. Trades, where terms are agreed upon or affirmed, are cleared trades.

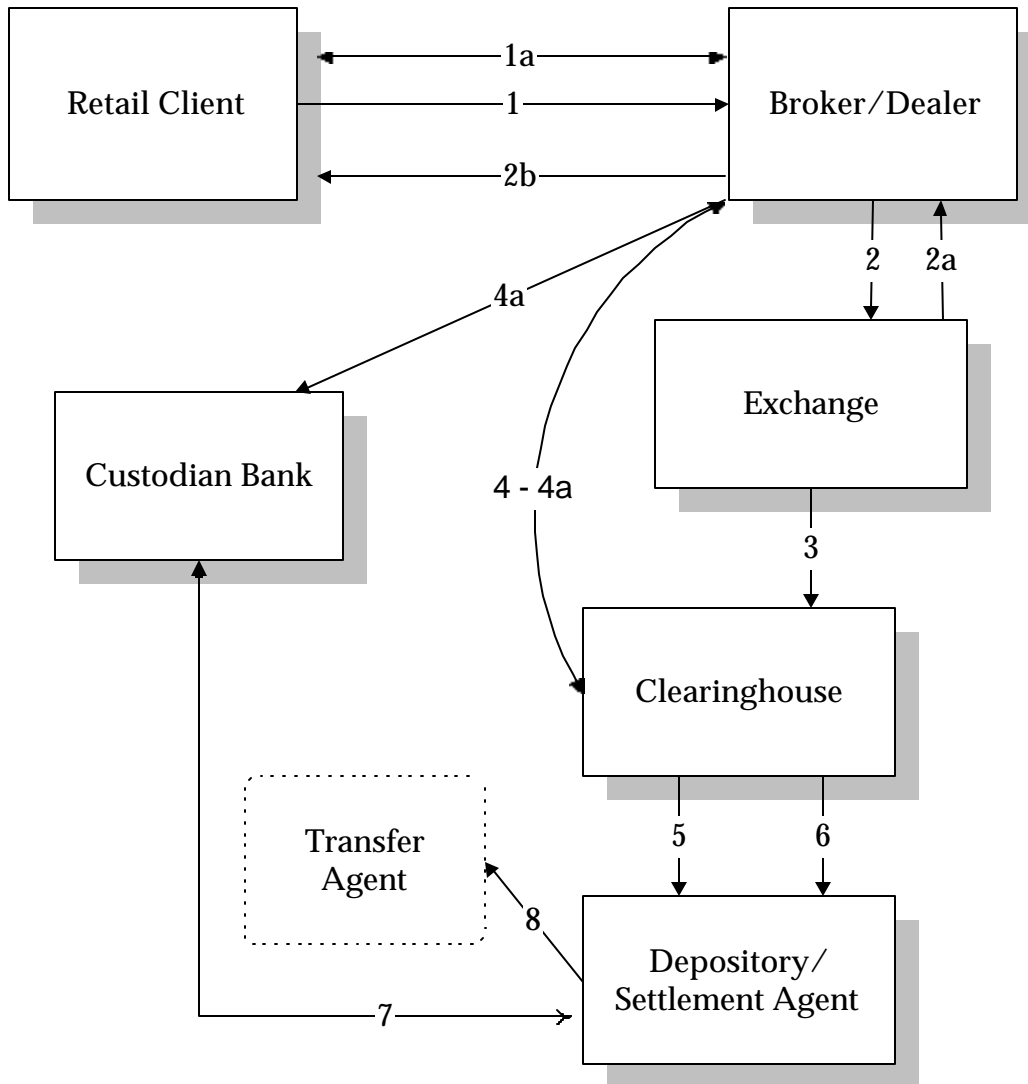
Settlement of trades occurs with the delivery of securities against payment for the securities. When trading activity grows to the point where financial sector participants are actively trading securities, it becomes very important that agreed upon trades are in fact settled and that trades do not fail for lack of delivery of the security or bouncing of the check in payment for securities. The only way to minimize settlement risk is to adopt the G-30 standard of delivery versus payment (DVP). In fact, in an ideal world and with heavy trading volume, it is necessary to approach real-time DVP. This objective reduces the risks of failed trades, which by the time a failure is known, the security may have been sold and re-sold several times. Thus, settlement failures can affect more parties than the two parties associated with a failed trade. Furthermore, DVP prohibits the same security from being fraudulently sold multiple times.

Additional functions that support a contemporary clearing and settlement system include a depository and custodians. The depository holds the physical securities and maintains electronic lists of official owners of each security. Virtually all government debt of developed nations and most institutional investors deal only with scriptless or dematerialized securities. Depositories can effect delivery of securities and show ownership of securities in a safer environment than use of physical securities. To make the system more efficient, the above noted support functions of clearing, settlement and depositories, typically only deal with “associated parties”. The associated parties (e.g., custodian banks for institutional investors and financial firms such as brokers) act on behalf of their clients (e.g., insurance companies, unit trusts, and individual investors). To reduce risks and improve efficiency, the clearing and settlement functions also use “netting” procedures so that the larger gross amounts (shares and money) are netted between associated parties. These entities must be electronically connected and trading information shared electronically.

Elaborating on custodial services, custodians are typically banks that specialize in developing the electronic infrastructure for providing clients with safekeeping of assets, settlement of security transactions, managing the collection of dividends and interest, and handling corporate actions (dividend payments, stock splits, proxy actions). These important custodial services also require audit and reporting capabilities.

The flow chart below depicts specific steps required to settle a security transaction for a retail client. In the case of institutional participants (e.g., insurance companies, pension funds), the institutional client typically manages many of the settlement and clearing functions performed by the broker. For example, the institutional client deals with their own custodian bank. Also, if involved in trading activities, the institutional client will affirm their own trades.

Security Transaction and Settlement Schematic



1. **Client** instructs **Broker** to place a trade.
- 1a. **Broker** and **Client** clarify trading instructions, modify trading instructions, etc.
2. Trade is consummated (see discussion of trading systems above).
- 2a. **Broker** is informed by **Exchange** of completed (consummated) trade.
- 2b. Both selling and purchasing **Brokers** confirm trade via written trade ticket to **Clients** and **Custodians**.
3. Trade tickets from **Exchange** floor sent to **Clearinghouse** for affirmation by participating **Brokers**.
4. **Clearinghouse** notifies **Broker** of consummated trade details (e.g., number of shares, price per share, commission, etc.).
- 4a. **Broker** affirms details of trade to their **Custodian** and **Clearinghouse**.
5. **Clearinghouse** informs **Settlement Agent** of cleared (affirmed) trades.

6. Trade is presented to **Depository** for delivery of security versus payment.
7. Simultaneously, **Custodian** pays (is paid) and receives (delivers) ownership of securities in book entry form at the **Depository**.
8. **Depository** informs **Transfer Agent** of change in ownership.

The growth in security transaction volumes in most financial markets of the world has led to more electronic inter-connectivity to achieve the proper controls and timely settlement of security transactions. Failure in these systems would cause catastrophic consequences. Thus, significant investment in computer systems is required on a continuous basis; on the order of hundreds of millions of dollars annually. Consequently, there has been significant consolidation in the settlement and clearing industry over the past several years. Amongst local banks, Barclays Bank is one of those banks providing these custodial services as is Standard Chartered Bank, which is a sub-custodian in Africa. Other global custodians include Cedel and Euroclear, institutions established specifically for these purposes. J.P. Morgan is another bank that is a recognized global custodian.

What significant conclusions can be drawn? First, these services provide insurance to investors. The protection of investors' assets is the most important purpose of these custodial functions. Most global custodians readily admit that they would, in practice, be forced out of commercial necessity to absorb losses incurred from any errors or mistakes they commit in the settlement process rather than lose investor confidence in the market. Second, global custody is essentially a utility function. These businesses incur extremely high barriers to entry with continuous required investment. Also, fees are extremely low. Thus, the marketplace cannot afford to support very many global custodians. Third, all of these support services make security trading more efficient, which improves transparency, liquidity, and reduces the cost of capital to the private sector. The increased market efficiency also makes regulation easier.

Foreign institutional investors require most of these infrastructure services before they will invest in emerging markets. Examples can be cited, such as India, where capital markets have developed without the associated clearing and settlement systems. In these cases, foreign investors have not participated in a significant manner.

Recommendations:

Local institutions providing custodial, clearing and settlement services should have experience or existing relationships in providing these services. The infrastructure support requirements, knowledge of standard conventions, and protection of investors' assets requires conformance with these internationally accepted practices.

The CMA should become affiliated with the International Society of Securities Administrators. The international association can be helpful in establishing a quick learning curve for the CMA and access to expert administrators when required.

The importance of automation should not be dispelled just because Uganda is an emerging capital market. Technology is an important element to insuring an adequate regulatory environment.

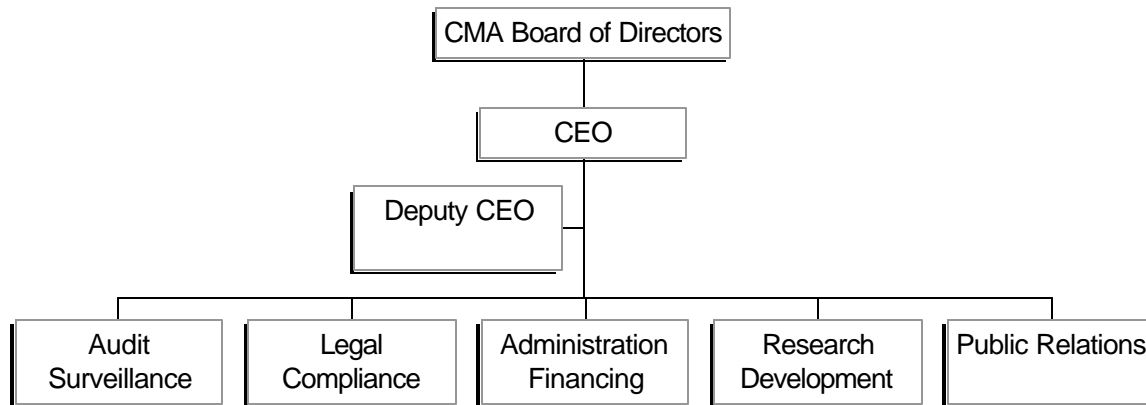
Delivery versus payment is the only viable settlement option. Electronic payment should result simultaneously with the (electronic) delivery of securities via a central depository. Serious consideration should be given to using a regional or money center depository and payment system, e.g., London, Johannesburg. As noted above, the costs are minimal and investor confidence is worth assuring.

5. Proposed Organizational Structure for the CMA

The foreign advisers were requested by the Chairman of the CMA to suggest an organizational structure for the CMA. The charts that follow depict the proposed organizational structure. The organizational structure reflects the basic duties of a standard regulatory body. The two major regulatory activities are located within two distinct divisions; an Audit and Surveillance Division, and a Legal and Compliance Division. Supporting the administrative functions required to operate most organizations is an Administration and Finance Division. This group provides the internal budgetary support functions and human resources support activities. The Research and Development Division is envisioned as a smaller group but very important in the ongoing analysis of market activities and other statistical analyses that support regulatory activities. Research and surveillance activities can be much more revealing and effective in achieving regulatory objectives than use of mandated compliance reporting rules. The Public Relations Division supports the organization's communications requirements with both the general public and the financial community. The executive structure proposed would include a Chief Executive Officer (CEO) and a Deputy CEO. As noted elsewhere in this report, it is critical that the CEO be experienced as a securities regulator. The Deputy CEO should be knowledgeable about Ugandan financial sector participants.

The three support divisions of Administration, Research and Public Relations should remain smaller staffed units. They will operate better as small, competent, responsive units. The size of the remaining two divisions will be determined by the capital markets and the workload imposed by the amount of trading activity, number of broker/dealers and the number of new issues.

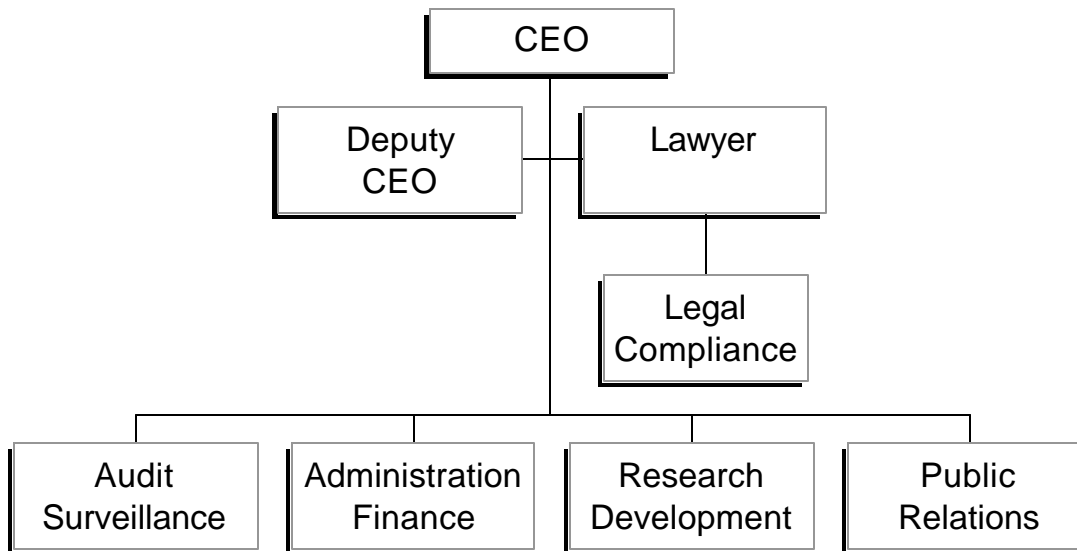
Functional Organization of CMA



Initially, the CMA staff should be comprised of three staff and a clerical support person. The CEO and Deputy CEO positions will provide the executive responsibilities necessary to build the regulatory organization. They will need to function as a team combining the experience as a regulator with the local knowledge about the regulated. Supporting these executives should be a legal adviser, who may not need to be full-time depending on the workload.

CMA Hiring Recommendations

Three employees



Summary and Recapitulation of Recommendations

The focus of activity for the training phase of the technical assistance was primarily with the Capital Market Authority, its board members and staff. With no securities exchange, limited securities to trade, and just authorizing organizations as dealers, the training focus necessarily addressed “getting started”. At these initial stages, the CMA needs to carefully develop its regulatory philosophy. To assist in this process, a review of the regulatory structures of the U.S., U.K., and Hong Kong served to illustrate alternative approaches.

Recommendations consist of the following:

1. A stronger regulatory approach is highly recommended, as it is important to develop and maintain investor confidence in the domestic capital markets.
2. It is recommended that the CEO position for the CMA and for the Exchange be filled with experienced, qualified professionals. These appointments are critical to the successful development of the Ugandan capital markets.
3. A “chalkboard” trading method is recommended for the Ugandan securities exchange. This simple, yet effective mechanism can be quickly implemented and can serve the needs of financial sector participants until such time as trading volumes are sufficient to justify an automated trading system.
4. Use of regional or money center clearing, settlement, depository, and payment systems are recommended. The importance of initially adopting state-of-the-art automation will support regulatory objectives.

5. Delivery versus payment is the only long-term viable standard for the settlement of security transactions.
6. Initially, a three-person organization is recommended for the CMA; a CEO, a deputy CEO, and an attorney.
7. The 1974 original law for Hong Kong forms the basis for the CMA law. Subsequently, several amendments were made in the Hong Kong law which are not included in the CMA law. Accordingly, it is recommended that Mr. McInnes' intimate knowledge about amendments and regulation within Hong Kong be used to develop amendments for the CMA law.

Appendix A

Training Schedule, Topics, and Attendance

December 9 - 10, 1996
Kampala Sheraton Hotel

Training personnel: David Weig, Uisdein McInnes, and Phillip Torres of IMCC, Andrew Spreadbury of Barents Group, KPMG

Attendance: Leo Kibirango, CMA Chairman; Simon Rutega, CMA Coordinator; Wasswa Kajubi, CMA; Stephen Kaboyo, CMA; Duncan Muhumuza, Legal Counsel to Ministry of Finance; Elijah Wante, Deputy Director of Law Development Centre.

Observers: Jim Gohary and Bruno Komakech, USAID (Tuesday, December 10, 1996)

Discussion Topics: Reviewed training agenda with participants and amended training program at the suggestion of the Chairman of the CMA. In addition, the Chairman of the CMA solicited the advisers' assistance in preparing for the CMA Workshop for Prospective Brokers, Dealers and Investment Advisers to be held on Thursday, December 12, 1996.

Reviewed regulatory framework in U.S., U.K., and Hong Kong. Discussed the importance of carefully identifying a regulatory philosophy at the outset in establishing capital markets. Emphasized benefits of stronger regulatory posture and primary importance of regulatory responsibilities of the CMA. Promotional efforts of CMA board need to carefully managed so as not to interfere with regulatory responsibilities.

In the development of capital markets, government securities typically play a major role in helping to develop an understanding of trading and interaction among financial sector participants. Thus, the T-bill issuance process and lack of secondary trading was also discussed during the initial training session. This topic was also included in the CMA Workshop and will receive more attention during the next advisor visit.

Tuesday, December 10, 1996

Reconvened training session with discussion of trading systems. Simulated trading activity using a chalkboard trading system. Also reviewed clearing and settlement activities which included a video showing these activities in the U.S.

Returned to discussions about the duties of CMA and presented two organization charts; one showing the functional organization and the other depicting the initial staffing structure. Discussed the proposed organizational structure and the importance of hiring an experienced CEO for the CMA and similarly for the securities exchange.

CMA Committee Meeting
Monday, December 16, 1996

Attendance: Leo Kibirango (CMA Chairman), Ruth Masika (Registrar General and CMA Board), Mr. Kawase (CMA Board), Bile Kainamura (Ministry of Justice and CMA Board), Simon Rutega (CMA Coordinator), Stephen Kaboyo (CMA), Elijah Wante (Deputy Director, Law Development Centre), Duncan Muhumuza (Ministry of Finance).

Advisors: David Weig, Uisdein McInnes, and Phillip Torres of IMCC, Andrew Spreadbury of Barents Group, KPMG

Discussion topics: Following a recap of various training topics previously discussed, subjects receiving greater interest and questions included: (i) a mock trading session, (ii) discussion of the merits of hiring experienced regulators and exchange administrators, and (iii) discussion of various examples of why an experienced regulator is recommended. For example, a discussion of initial public offerings and how distributions among interested investors can be manipulated and what regulators can do to monitor these situations reinforced the recommendation as to why an experienced regulator is required for the CEO position. Illustrating the creativity of the financial participants and the application of experience in achieving regulatory oversight seemed to be received with great interest.

Appendix B

Workshop for Prospective Brokers, Dealers, and Investment Advisors

Thursday, December 12, 1996
Kampala Sheraton Hotel

Hosted by the CMA, this workshop was designed to inform the newly licensed merchant banks, financial organizations seeking to become broker/dealers, and selected government officials about the status of the development of the CMA and its regulatory responsibilities. The Authority officially opened for business on this day, December 12, 1996.

Financial institution representatives attending the workshop included: Capital Alliance (Tony de Castro), Transafrica Bank (Mr. Sukara), Pryor McClendon Counts & Co. (Andrew Owiny), East Africa Bank, Stanbic Bank, Barclays Bank, and Crane Bank.

Speakers at the workshop included: the Honorable Joshua Mayanja-Nkangi, Minister of Finance; the Honorable Richard Kaijuka, Minister of Economic Planning; Mr. Rwakakooko, Chairman of Uganda Commercial Bank; Mr. Moi representing the Governor of the Bank of Uganda; Mr. Leonard Muganwa, Executive Director of the Parastatal Monitoring and Privatization Unit; and other senior level participants. An IMCC representative addressed the workshop, responded to questions, and raised potential issues.

The foreign advisors emphasized that the financial market participants need to assume responsibility for operation of the Exchange and guide future development of the capital markets. The Government of Uganda has taken the lead in establishing the legislation for capital markets to emerge and grow but it is the specific responsibility of the private sector to carry out future activities.

Appendix C

Evaluation Report By Uisdein A. McInnes, former Commissioner of Securities for Hong Kong

UGANDA - CAPITAL MARKETS AUTHORITY DECEMBER, 1996

After a somewhat hesitant start when the chairman seemed equally at unease with the organizers on the one hand, and the paucity of attendees, organized (or not) by his CMA staff on the other, the atmosphere improved rapidly as the presentations were made. I believe the Chairman and members of the CMA were more than satisfied with the presentations, especially since, at the end of the preliminary three days, the Chairman requested a separate afternoon's summation and discussion for the following Monday.

There are, however, four distinct and potentially disturbing aspects involving the philosophy of the CMA (as expressed by the Chairman); the exact position of the stock exchange (which one?); the presentation and timings of the new IPOs from the privatization programme, and the underlying securities legislation.

I believe the Chairman was one of the co-founders of the Kampala Stock Exchange. Unfortunately, he does not seem to differentiate between his former and current roles. He really does seem to hold the strong view that the CMA must run the stock exchange. By the end of the round of meetings and in discussions, his original views may have been somewhat dissipated -but I do not believe they were entirely eradicated. The function of a Regulatory Agency is to regulate - not run the whole securities/financial sector. The CMA seems to be of the view that the stock exchange (by whatever name it will be called - Kampala or Uganda) is the securities industry. It is not. There are a plethora of other activities and individuals who have to be regulated and registered, ranging from securities brokers who are not members of the stock exchange, investment advisers, pool operators, unit trusts and mutual funds, to name but a few. The precise role and philosophy of the CMA has to be more clearly defined - the CMA is a referee not a player.

Which brings me to the stock exchange. I am somewhat perturbed by the involvement of the CMA in the stock exchange - but which? The Kampala Stock Exchange (in de jure if not de facto existence) or the Uganda Stock Exchange? (Neither). It is recommended that a stock exchange be allowed to develop from the bottom rather than be imposed from the top. The demand and impetus for an exchange should preferably be initiated by market professionals who work together to establish an exchange, draw up its Constitution, Listing Rules, and its Rules and Regulations. All of these should be the by-product of the work of market professionals - all to be approved subsequently by the regulatory authority.

For example, when a company seeks a listing on the exchange by way of an IPO, the prospectus for that

issue is drawn up by the company's legal advisor, the sponsoring broker or underwriter if there is one, and the company in accordance with the listing requirements of the exchange. The regulatory authority confirms only that a prospectus complies with all legal requirements. The authority passes no qualitative judgment at all and also plays no role in determining the issue price. This latter is the sole responsibility of the market professionals, the company and its advisers to other with the listing committee of the exchange.

Which brings me to the third point. I obtained the impression - rightly or wrongly - that there appears to be little coordination between the respective authorities and the privatization authority regarding both the timetable and details of which company should come to the market. There was a lot of loose, general talk whether or not to permit an official discount to the issuing price or offer vouchers. This has definitely to be corrected. If the Government wishes to see a successful stock market and financial sector, there must be closer cooperation between the relevant parties. But, it is essential that, publicly at least, the initial listing price of an IPO is seen to be determined by the market - not influenced by the government. Those responsible for setting the issue price (company, broker, exchange) will surely have taken cognizance of all material factors in determining the price. In the final analysis, it must be a figure the market can absorb successfully. The investing public must see that the issue price was determined freely by market professionals and not (overtly) influenced by other parties.

Which leaves the final point - the underlying basis of the legislation covering the securities industry. The Capital Markets Authority Statute (and its relevant regulations) has already been passed into law. The statute seems to be based mainly on the 1974 Hong Kong Securities Act, which has been subsequently amended. This report is not the correct forum in which to comment in detail on the content of the legislation. (This can be done, if required, separately, but would take at least 2/3 days). Suffice it to say, specific attention should be drawn to certain provisions already contained relating mainly, but not exclusively, to the establishment of a compensation fund, the banning of short selling and provisions relating to the granting of exemption (to registration). These three areas, at least, need much closer examination.

One final comment needs to be made. Both the CMA and the Stock Exchange seem to lack adequate experienced personnel. For both to be successful, it is essential that both have available to them personnel with appropriate qualifications and direct securities/financial supervisory experience. The repercussions of the failure of the stock market spread much wider than the market itself and have significant implications for the economy as a whole. The public perception, both local and international, must be such that they see the market is played by professionals and is regulated by an independent authority both of whom respect each others' professional integrity.

One more final comment. I believe a 2/3 day hands-on workshop would be of value, not only to the CMA but the exchange, prospective members, and the privatization authority. Everything could be enacted from case studies to be determined by the CMA: what, and who, determines the initial price of an IPO; a review of disciplinary procedures on licensed persons, an accepted code of conduct for licensed persons, as well as the exchange trading procedure and the execution of a client's order from inception to conclusion. Such a workshop would, in my view, go a long way to delineating all the

functions and responsibilities of each of the separate, constituent elements that will go to make the securities market in Uganda.

Uisdein A. McInnes

Appendix D

Training Materials

The following training materials are attached:

1. Statutory and Regulatory Framework of the Securities Industry: Too Much, Too Little, or Somewhere in Between?
2. Opening Remarks to CMA Board and Staff By Uisdien McInnes, former Commissioner of Securities in Hong Kong
3. Clearing and Settlement

Statutory and Regulatory Framework of the Securities Industry:

Too Much, Too Little, or Somewhere in Between?

US

Strict regulatory controls under the Securities and Exchange Commission (SEC), which basically evolved from 1929 through 1940.

Clear cut distinction between securities and futures; SEC vs. Commodity Futures Trading Commission (CFTC).

UK

Financial Services Act of 1986 (FSA) introduced self regulation within a statutory framework.

Securities and Investment Board (SIB) delegated powers by FSA.

SIB recognized several SROs.

Limited power of regulation by SROs.

No distinction between Securities and Futures.

Hong Kong

Laissez Faire approach.

First regulatory control introduced in mid-1970s.

Legislation since amended

Distinction between Securities and Futures but both regulated by same office; saving in manpower/expertise.

Recommendation

Stronger but intelligible regulation.

Opening Remarks to CMA Board and Staff

By Uisdien McInnes, former Commissioner of Securities in Hong Kong

At this juncture, I should like to express my strong views that the appointment of suitable, qualified persons to be the CEO of the Authority, and the Exchange respectively, are pivotal to the success of the whole operation. One cannot, of course, state that the appointment of qualified persons will automatically ensure success, but one can say that the appointment of unqualified candidates will severely, if not totally, limit the chance of success.

The qualifications for the candidate for the CEO to the Authority should have, at a minimum, several years of regulatory experience in the regulatory sector-preferably securities. For the post of CEO of the exchange a candidate must have several years of experience at a high level in a recognized stock exchange; e.g., in Hong Kong the first CEO of the exchange in Hong Kong (the newly amalgamated exchange) had previously held the post of CEO of the London Stock Exchange.

The investing public have a right to expect qualified professionals at its regulatory authority whilst the exchange must know it is dealing with knowledgeable professionals of at least equal seniority. The two bodies have to respect the professionalism of the other.

I recommend the above to you for your most serious consideration.

Thank you.

Clearing and Settlement

Establishing risk controls upon completion of trades on the floor.

Clearing

Verification by both brokers of transaction details (name, quantity, price from both Buyer and Seller).

Settlement

Delivery versus payment (DVP)

Delivery can be made in physical form or book entry (depository)

Recommendation

Book-entry for all securities

Custodian Bank correspondent relationship with Global Custodian

Delivery versus Payment

Depository relationship with EuroClear or Cedel